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No. 71-1280

In the Supreme Court of the United States

OCTOBER TERM, 1971

B. FORMAN COMPANY, INC., ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The opinion of the Tax Court (Pet. App. A17-A39) is reported at 54 T.C. 912. The opinion of the court of appeals (Pet. App. A40-A72) is reported at 453 F. 2d 1144.

JURISDICTION

The judgment of the court of appeals was entered on January 10, 1972 (Pet. App. A73-A74). The petition for a writ of certiorari was filed on April

6, 1972. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether, for purposes of invoking Section 482 of the Internal Revenue Code of 1954, two unrelated corporations having a common interest, and a third corporation owned equally by them in pursuit of that interest, are "two or more organizations, trades, or businesses * * * owned or controlled * * * by the same interests."

2. Whether, assuming petitioners and their joint subsidiary (Midtown) were under common control, the Commissioner had the authority to utilize Section 482 to allocate interest income to petitioners on interest-free loans which they made to Midtown, irrespective of whether any of the corporations realized gross income from outside sources as a direct result of the loans.

STATUTES AND REGULATIONS INVOLVED

The provisions of Section 482 of the Internal Revenue Code of 1954 are set forth in the petition (Pet. 3). The pertinent provisions of Sections 1.482-1 and 1.482-2 of the Treasury Regulations on Income Tax are set forth in the Appendix to the petition (Pet. App. A1-A16).

STATEMENT

Petitioners, B. Forman Company, Inc. and McCurdy and Company, Inc., are corporations which

during the taxable years in controversy operated competing department stores on adjacent sides of the same block in downtown Rochester, New York. They were owned by the Forman and McCurdy families, respectively, and had no common shareholders, directors or officers. (Pet. App. A18-A19.)

In 1958, petitioners organized Midtown Holdings Corporation ("Midtown") for the purpose of constructing and operating an enclosed mall shopping center and office building complex adjoining their stores. Upon incorporation, each received 50 percent of Midtown's issued and outstanding stock. They subsequently executed a written agreement which provided that additional stock purchases from Midtown would be made equally by each petitioner and that each would have equal representation on Midtown's board of directors. If either party so requested, an additional director could be appointed, either by mutual consent or, if there was a dispute, by an independent third party. During the relevant taxable years, Midtown had four directors, two representing each petitioner. (Pet. App. A20-A21, A43-A46.)

Petitioners also agreed to loan funds to Midtown from time to time. These loans were to be made in equal amounts and were to be evidenced by notes or other evidences of indebtedness bearing interest at five percent per annum, with principal due and payable 30 years after issuance. (Pet. App. A21, A44-A45.)

Construction of the shopping mall commenced in 1959. To help finance the project, petitioners made

several loans to Midtown, which were consolidated into 30-year notes totalling $662,500 to each petitioner and bearing interest at five percent per annum. Midtown paid off these notes in July, 1959, from the proceeds of a line of credit established with Lincoln Rochester Trust Company. (Pet. App. A21-A22, A46-A47.)

In September, 1960, each petitioner loaned Midtown an additional $1,000,000 and took back three-year notes, bearing interest at three and one-half percent per annum. In April, 1961, the notes were cancelled without payment of principal or interest and replaced by three-year notes, in the same principal amount, but bearing no interest and dated back to September 9, 1960. These noninterest-bearing notes were renewed for new three year terms on September 9, 1963 and September 9, 1966. During the period when the interest-free loans remained outstanding, petitioners each borrowed in excess of $1,000,000 from various commercial banks, at interest rates averaging at least five percent per annum. Midtown also borrowed amounts from commercial lenders during this period at interest rates ranging from four and one half to six percent per annum. (Pet. App. A22, A47-A48, A64; R. 67.)[1]

Acting pursuant to Section 482 of the 1954 Code and the Treasury Regulations issued thereunder, the Commissioner allocated $50,000 in interest income to

[1] "R." references are to the separately bound Appendix filed in the court of appeals. "Ex." references are to exhibits introduced at the trial.

each petitioner during their fiscal years 1965 through 1967, and determined deficiencies accordingly. The allocation was based on an arm's length interest rate of five percent per annum on the $1,000,000 loans to Midtown and was made to reflect petitioners' income clearly, as mandated by Section 482 (Pet. App. A18, A30-A31, A48.)

Petitioners each sought redeterminations in the Tax Court, where the cases were consolidated. That court held that the Commissioner had no authority to invoke Section 482, because petitioners and Midtown were not owned or controlled by the same interests, as required by the statute. Having held that the requisite statutory control was lacking, the Tax Court had no occasion to consider the propriety of the Commissioner's allocation. (Pet. App. A30-A34.)

On appeal, the Second Circuit reversed, initially holding that petitioners and Midtown were two or more commonly controlled trades or businesses (Pet. App. A47-A59). It then sustained the Commissioner's allocation, reasoning that (Pet. App. A60) "[r]eallocation is necessary here in order to properly reflect the income of taxpayers and Midtown." The court also approved of the five percent arm's length interest rate utilized by the Commissioner[2] (Pet. App. A63-A64).

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[2] Another issue before both courts below, relating to the deductibility under Code Section 162 of certain payments made by petitioners to Midtown, has not been raised in the petition, and the determination of that issue is now final.

ARGUMENT

The decision below is correct. There is no direct conflict of appellate court decisions or any other basis for further review at this time.

1. Section 482 of the Internal Revenue Code of 1954 empowers the Commissioner to allocate gross income among "two or more organizations, trades, or businesses * * * owned or controlled directly or indirectly by the same interests * * * if he determines that such * * * allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations * * *." Considered only recently in a different context by this Court in *Commissioner* v. *First Security Bank of Utah*, No. 70-305, this Term, decided March 21, 1972, the statute is a continuation of prior law enacted to permit the Commissioner "to deny [to taxpayers] the power to shift income * * * arbitrarily among controlled corporations, and to place such corporations rather on a parity with uncontrolled concerns." *Central Cuba Sugar Co.* v. *Commissioner*, 198 F. 2d 214, 216 (C.A. 2); see H. Rep. No. 2, 70th Cong., 1st Sess., pp. 16-17; S. Rep. No. 960, 70th Cong., 1st Sess., pp. 24-25.

The threshhold finding of the court of appeals that petitioners and their joint subsidiary, Midtown, were two or more trades or businesses owned or controlled by the same interests fully accords with the language and purpose of Section 482, as well as the applicable Treasury Regulations and the trend of recent appellate court decisions. Congress drafted the statute

broadly so that it would embrace all types of taxable entities which are "controlled," even "indirectly," by the "same interests." Unlike other Code sections which precisely define the term "control" (see, *e.g.*, Sections 269(a), 318(a), 368(c), 957(a), 1551), Section 482 does not speak in terms of percentages of stock ownership. To the contrary, as the Regulations have long provided, it is the "reality of control" which is critical, and any kind of control, direct or indirect, and however exercised, is sufficient to justify application of the section. Treasury Regulations on Income Tax (1954 Code), Section 1.482-1 (a)(3). This liberal construction effectuates the underlying policy of the statute and has won increasing judicial recognition and approval.[3]

Applying the foregoing criteria to the uncontroverted facts of this case, the court of appeals concluded that (Pet. App. A56) petitioners' "interests in the existence and career of Midtown and the interests of Midtown are identical." The court properly recognized that in their dealings with Midtown, petitioners were not two unrelated businesses acting separately. Rather, they were joined by a common

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[3] See *Hall* v. *Commissioner*, 294 F. 2d 82 (C.A. 5); *Ach* v. *Commissioner*, 42 T.C. 114, affirmed, 358 F. 2d 342 (C.A. 6), certiorari denied, 385 U.S. 899; *Borge* v. *Commissioner*, 405 F. 2d 673 (C.A. 2), certiorari denied *sub nom. Danica Enterprises, Inc.* v. *Commissioner*, 395 U.S. 933; *Advance Machinery Exch.* v. *Commissioner*, 196 F. 2d 1006 (C.A. 2), certiorari denied, 344 U.S. 835. See also Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders*, Sec. 15.06 (3d ed., 1971).

interest and invariably acted in concert vis-á-vis Midtown, as they were obligated to do by an explicit written agreement. Realistically, control by the same interests is present here no less than if petitioners had created an equal partnership to deal with Midtown, and had they followed that course, their transactions clearly would have been subject to scrutiny under Section 482. See, *e.g.*, *Grenada Industries, Inc.* v. *Commissioner*, 17 T.C. 231, affirmed, 202 F. 2d 873 (C.A. 5), certiorari denied, 346 U.S. 819; *South Texas Rice Warehouse Co.* v. *Commissioner*, 366 F.2d 890 (C.A. 5), certiorari denied, 386 U.S. 1016; *Forcum-James Co.* v. *Commissioner*, 7 T.C. 1195, remanded pursuant to stipulation, 176 F. 2d 311 (C.A. 6); Rev. Rul. 65-142, 1965-1 Cum. Bull. 223. Under these circumstances, the court of appeals reached the right conclusion.

There is no conflict among the circuits on this point. While suggesting (Pet. 21) that "the courts" have rejected the Commissioner's expansive construction, petitioners refer only to *Lake Erie & Pittsburg Railway Co.* v. *Commissioner*, 5 T.C. 558, whose rationale is not reconcilable with that of the later decisions and which provides no basis for review by this court.[4] Moreover, issues such as those involved both

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[4] *Lake Erie* represents an isolated holding, characterized as "questionable" by respected tax law commentators. See, *e.g.*, Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders*, Sec. 15.06 (3d ed., 1971); Hewitt, *Section 482—Reallocation of Income and Deductions Between Related Persons—Up to Date*, 22 N.Y.U. Inst. on Federal Taxation 381, 384 (1964).

here and in *Lake Erie*, although fundamental, often depend upon an evaluation of particular facts, such as the nature of the joint enterprise, and the terms and conditions adopted by the controlling shareholders for dealing with their subsidiary. As a result, questions of control are not readily resolved by means of a legal rule of general applicability. In any event, absent a conflict among the circuits as to the proper legal rule, further review is not warranted.

2. Having properly resolved the control question, the court of appeals was also correct in upholding the Commissioner's authority to allocate interest income to petitioners. In testing an allocation under Section 482, the "standard to be applied * * * is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer." Treasury Regulations Section 1.482-1(b)(1), quoted by this Court in *Commissioner* v. *First Security Bank of Utah*, *supra*, p. 6. The Commissioner's authority extends to any instance where, either by inadvertence or design, the income of commonly controlled taxpayers is different than it would have been had they dealt with each other at arm's length. *Oil Base, Inc.* v. *Commissioner*, 362 F. 2d 212, 214 (C.A. 9), certiorari denied, 385 U.S. 928; *Baldwin-Lima-Hamilton Corp.* v. *United States*, 435 F. 2d 182, 185 (C.A. 7). Moreover, innocent distortions of income, as well as tax avoidance motives, will support an application of Section 482 (*Philipp Brothers Chemicals, Inc. (N.Y.)* v. *Commissioner*, 435 F. 2d 53, 57 (C.A. 2)), and the Regulations authorize an allocation of gross

income "notwithstanding the fact that the ultimate income anticipated * * * may not be realized or is realized during a later period" or even though the income "is never, in fact, realized by the other members" (Treasury Regulations Section 1.482-1(d)(4)).

A proper application of the arm's length standard here requires that the Commissioner's allocation be sustained. During the very period in which petitioners were making substantial loans to Midtown at no interest, they themselves were borrowing from unrelated lenders at interest rates averaging at least 5 percent. Had Midtown borrowed $2,000,000 from an unrelated source (or even from petitioners in an arm's length transaction), it obviously would have been obligated to pay a fair rate of interest, and its gross income would have been reduced accordingly. Conversely, although petitioners parted with the use of their money, they received no compensation for its use, thereby decreasing the gross income they would have earned had they made an arm's length loan. To contend, as petitioners do (Pet. 10-18), that the Commissioner may not invoke Section 482 under these circumstances would sanction the very type of income distortion which Section 482 was designed to prevent and, in the words of the court of appeals (Pet. App. A62), "seriously impair the usefulness" of the statute.[5]

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[5] The allocation made in this case is specifically authorized by Treasury Regulations Section 1.482-2(a), which provides:

[Footnote continued on page 11]

3. Despite the foregoing, petitioners seek further review of the allocation upon the ground that the Commissioner impermissibly "created" income where none in fact existed, and they assert conflict on this principle between the holding below and *Tennessee-Arkansas Gravel Co.* v. *Commissioner*, 112 F. 2d 508 (C.A. 6). In that case, the court rejected the Commissioner's attempt to attribute rental income, under the allocation authority of Section 45 of the Revenue Act of 1934, c. 277, 48 Stat. 680, to a taxpayer which had been leasing equipment on a rent-free basis to a commonly controlled affiliate. While admittedly there may be a conflict in principle as to the scope of the Commissioner's allocation powers, its nature is not such as to warrant resolution by this Court at this time.

(a) The current Section 482 Regulations ensure that income will not be "created" under the circumstances of this case, by requiring that correlative adjustments be made to the income of the controlled entity from which an allocation has been made. Treasury Regulations Section 1.482-1(d)(2). Thus,

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[5] [Continued]

> Where one member of a group of controlled entities makes a loan or advance directly or indirectly to, or otherwise becomes a creditor of, another member of such group, and charges no interest * * * the district director may make appropriate allocations to reflect an arm's length interest rate for the use of such loan or advance.

The court of appeals upheld the Regulations as (Pet. App. A62) "entirely consistent with the scope and purpose of § 482."

the reallocation involved here not only results in an increase in petitioners' income, but also in a reduction in Midtown's gross income.[6] As long as this procedure is followed, income is allocated, not created, and the controlled parties are placed on a tax parity with uncontrolled taxpayers—precisely the result contemplated by Section 482.

(b) The holding below is the first appellate decision construing present Treasury Regulations, which not only define the principle of an arm's length transaction but also deal specifically with interest-free loans and other intercompany transactions.[7] In con-

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[6] Midtown clearly had gross income during the years in question, but it operated at a net loss for two of those three years. (R. 37; Exs. 35-AI, 36-AJ, 37-AK.) The correlative adjustment thus will be reflected by increased net operating loss carryovers, which will be available to offset Midtown's income in future years. The Commissioner does not limit application of Section 482 to situations where commonly controlled taxpayers all show pre-tax profits for the obvious reason that loss corporations, like preferentially taxed foreign corporations or domestic life insurance companies, present clear opportunities for shifting of otherwise taxable profits.

[7] Regulations Section 1.482-1(d) (dealing with methods of allocation) and Section 1.482-2 (setting forth allocation procedures for specific situations, such as loans or advances) were initially proposed on April 1, 1965 (30 Fed. Reg., Part 4, 4256), reproposed and amplified on August 2, 1966 (31 Fed. Reg., Part 8, 10394) and formally adopted, except for one section, on April 15, 1968 (T.D. 6952, 33 Fed. Reg., Part 4, 5848). Generally, the Regulations apply to all open years. T.I.R. 836, 1966 C.C.H. Stand. Fed. Tax. Rep., par. 6679. These Regulations were promulgated as a result of a Congressional directive to the Treasury to "explore the possibility of developing and promulgating regulations under * * * [the

trast, the decision in *Tennessee-Arkansas Gravel*, arrived at over 30 years ago, antedated judicial development of the arm's length standard. Admittedly, if the Sixth Circuit's holding is taken to mean that no allocation of income can be made with respect to any transaction in which the related parties have not provided for income realization, or that no allocation is proper until income is realized from outside the controlled group, it conflicts with the principle advanced below. But the rationale used by the court in 1940 is far from clear, and the decision—which does not even advert to the arm's length standard—can hardly be taken today as an authoritative ruling by the Sixth Circuit which restricts the scope of the Commissioner's allocation powers under Section 482.

Moreover, the asserted conflict is by no means a square one, since in *Tennessee-Arkansas Gravel* the Commissioner had increased the taxpayer's income without giving a corresponding deduction to the corporation from which the allocation was made. Since income had indeed been created, the court properly upset the allocation, but at the same time suggested (112 F. 2d at 510) that the Commissioner might—as he has done here—use the predecessor of Section 482 to reallocate some of the reported gross income from

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authority contained in Section 482] which would provide additional guidelines and formulas for the allocation of income and deductions in cases involving foreign income" (H. Conf. Rep. No. 2508, 87th Cong., 2d Sess., p. 19), and they apply equally to shifting of profits between domestic trades or businesses.

one of the related taxpayers to the other. For this reason, the Commissioner has concurred in the result reached in *Tennessee-Arkansas Gravel* to the extent that the holding is based on his failure to have made a correlative adjustment. See Rev. Rul. 67-79, 1967-1 Cum. Bull. 117.[8]

4. As petitioners suggest (Pet. 7-10, 18), there are a number of pending cases in various stages of litigation dealing with aspects of the Commissioner's

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[8] It is true that several Tax Court decisions cited by petitioners (Pet. 13-17) have extended the holding in *Tennessee-Arkansas Gravel.* We disagree with those decisions but even they are not in square conflict with the holding below. In *Smith-Bridgman & Co.* v. *Commissioner,* 16 T.C. 287, acq. 1951-1 Cum. Bull. 3 (acquiescence explained in Rev. Rul. 67-79, 1967-1 Cum. Bull. 117), the court observed that it was "apparent" that the Commissioner did not allocate gross income to the taxpayer, "since the record shows that he made no adjustment to the income or deductions" of the taxpayer's affiliate. 16 T.C., p. 294. Although the correlative adjustment problem was not present in *PPG Industries* v. *Commissioner,* 55 T.C. 928, the rejection of the interest allocation there apparently rested on the fact that the loans in question had been made many years prior to the year of allocation. Limiting its decision to the "circumstances of this case," the court stated (55 T.C., p. 1009) "We need not decide whether * * * [the Commissioner] may, under the authority of section 482, make an allocation of income which is indistinguishable from the imputation of an interest charge." *Huber Homes* v. *Commissioner,* 55 T.C. 598, does purport to hold that Section 482 allocations must be based on specific income realized from dealings with third parties. But, as in *PPG Industries,* the Tax Court limited its decision to the facts of the case and refrained from passing upon the validity of the Regulations approved by the court below. At all events, any conflict in principle between these Tax Court cases and the decision below does not warrant review by this Court.

allocation powers under Section 482. The issues presented here, although important, are but two of a broad range of legal and factual questions, some of which may ultimately have to be resolved by this Court. At this time, however, there is no conflict in principle on the control issue, and, since the adoption of the applicable Treasury Regulations, the court below is the only appellate court that has considered the allocation issue here involved. In these circumstances, plenary consideration by this Court would best await further developments in the courts of appeals and a conflict of decisions if one should ultimately occur.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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